

March 19, 2007

United States House of Representatives  
Committee on Energy & Commerce  
Washington, DC 20515-6115

Dear Sirs:

In response to your public letter of February 27 and the questions contained, IETA's US Working Group has prepared the following comments in response.

1. The imposition of a carbon constraint will have a real impact on the US economy. The cost of carbon will be incorporated into the prices of consumer goods and certain economic sectors that rely on fossil fuels will be impacted.

The key goal of policy design should be to limit any adverse impacts. The major elements of such a design would include an emissions cap that starts modestly in order to allow the economy to adjust to the carbon price and a functioning market that provides incentives for both consumers and industry to reduce their emissions and take actions that minimize compliance costs. The market will allow effective discovery of a price for carbon, act as a powerful incentive to minimize overall social costs and enable the private sector to invest their resources in a way it deems most appropriate to meet their economic objectives.

We believe that these goals and simplicity should guide the committees' deliberations. Other emissions control legislation designed by the Energy and Commerce committee incorporated similar design elements and achieved environmental objectives at costs that were less than forecast.

2.a. IETA supports a cap and trade system that covers as high a percentage of national emissions as is practicable. Broad coverage of sectors with different marginal costs of control allows for the market to achieve cost savings. The different marginal costs of regulated firms covered by the system allows firms to sell emissions rights to others whose internal control costs are higher creating a win-win for both. This creates a revenue stream for sellers providing incentives for investment in additional reduction measure while creating incentives for cost control for firms whose internal control costs are higher. This will occur to a greater extent by covering as high a percentage in the program as possible. .

A key question in the design of an emissions trading system is the treatment of transport sector emissions. Emissions from this sector are rising rapidly. An effective



emissions trading program ideally places the constraint at the point of the activity which creates the actual emissions. This provides a price signal to affect behavior. This is clearly challenging with respect to the personal transport sector given the magnitude of sources and that consumer transport emissions have been shown to be relatively unresponsive to a price signal. This would suggest that inclusion of the road transport sector in a cap-and-trade system could be less effective than for other sectors.

These challenges must be weighed against the consideration to include the highest percent of emissions in a trading system in order to achieve the benefits stated previously. The sector comprises too large of a percentage of the economy's overall emissions to be excluded indefinitely. Equity across all sectors of the economy is an important consideration for the committee to consider as it develops and debates legislation. In addition, alternative policy measures may well be significantly less efficient than a cap and trade system in achieving environmental and economic costs. We believe that options are available that would allow a program to capture emissions from transport fuels.

b. Congress should incorporate as much detail as possible in climate control legislation. Principles and key implementation details should not be left to the agencies administering the statute. We believe that the most effective legislation could be developed by the Committee given the diversity of its membership. It consists of Members from the key regions of the country that could be most affected by such legislation.

c. As noted in our response to 2.a., a core principle in the design of an emissions trading systems is to impose the constraint at the point of activity which creates the emissions. This provides the greatest incentive for the emitter to take actions which reduce emissions and control cost.

IETA believes that that the constraint should be imposed downstream for covered stationary sources such as power plants and energy intensive manufacturers. The constraint and the provision of allowances to such sources has the greatest potential to achieve the objective of cost control. These sources would be powerfully incented to reduce their emissions at the lowest possible cost. Legislation and regulation that controlled conventional air pollutants such as sulphur dioxide (SO<sub>2</sub>) and oxides of nitrogen are examples of this approach that can be emulated. In addition, significant capacity to measure CO<sub>2</sub> emissions is already in place for the power sector.

It is clear that some sectors are most effectively included with an upstream regulatory structure. In order to broaden the scope of the market, it is necessary to consider some measure of compromise in the design approach. As such, IETA would recommend a hybrid approach using a downstream design as the initial point of departure.



d. The use of large scale auctions as some parties are proposing is a risky undertaking that ignores the realities of market formation. Any such use of auctioning as an allocation method for emissions trading should be carefully considered on the basis of both equity and efficiency. Auctioning has significant appeal as an allocation method for an emissions trading system, and may address some of the outcomes that have been observed in emissions trading programs in other jurisdictions. However, there is reason to believe that the use of 100% auctioning to initiate an emissions trading system is not optimal on either count, and will result in far greater economic impact on emitters than is necessary to achieve the environmental objectives.

Many of the arguments deployed in support of extensive use of auctioning rest on a conflation of two issues: observed effects of marginal cost pricing in electrical markets and the purposes of an allocation process for emissions trading. A gradual transition to more extensive use of auctioning would be more prudent public policy, realizing efficiency gains from a more effective market while striking a compromise on the inevitable issues of equity. The allocation process should not be called upon to achieve the policy objectives of the program, merely to initiate the process and allow the power of the market to drive abatement.

An inherent risk of large initial auctioning is that the auction may emerge as an alternative to a competitive carbon market. Further, the use of initial large auctions runs the real risk of significantly increasing compliance costs with no additional environmental benefit. Both of these considerations suggest the wisdom of the cautionary principle.

Any allocation of permits involves distributional consequences. Auctioning permits could be seen as transferring wealth equivalent to the new cost of carbon from liable parties and energy users to taxpayers. Free allocation of permits assigns rents to the recipients—at the expense of taxpayers and/or energy users, depending on the structure used, but not necessarily at any new incremental expense.

IETA recommends that in the design of the legislation allocation be very carefully considered as a portfolio design process, with any use of auctioning viewed as the introduction of a potential shock as well as the coincident introduction of a carbon constraint. Congress should clearly set forth the principles governing allocation and the timetable for any transition involved.

IETA opposes the use of the allocation process to reward non-emitting sources. For technologies that public policy has deemed of long term importance to reducing emissions, there are more efficient instruments available to assist competitiveness. For non-emitting energy sources, allocation of allowances will simply be a transfer of marketable assets unaccompanied by any obligation to surrender these allowances as a compliance instrument. A well designed program provides these sources a benefit by increasing the costs for emitting sources. This price signal will increase the competitiveness of the non-emitting sources. The market is quite able to send the



appropriate investment signal to this sector without the need to complicate the allocation portfolio design.

e. Simplicity is a virtue in the design of environmental markets. As such we recommend that the limit be absolute in nature. The legislation should provide covered sources a fixed or quantitative target on an ex ante basis and be provided their allowances at that time. This approach provides certainty to those that will be regulated and also provides predictable environmental outcomes. This approach is in contrast to programs that utilize a target based on some level of economic activity and provide allowances to entities on an ex post basis. These programs have not been effective in the past.

f. The actual level of any cap is best left to elected officials and those that best understand the implications of alternative emissions limits on the climate system and for the economy. IETA does not participate in the scientific discussion of climate change. As such, we do not have a view on the appropriate level for the cap over time except in the context of market principles.

We would recommend that the Committee consider the following in establishing the cap.

The goal of the UN Framework on Climate Change (UNFCCC), which the US is a party to, is to stabilize concentrations of carbon dioxide in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system. This targeted level has not been agreed to. However, under most trajectories that have been explored, emissions must peak and decline on a global basis in order to achieve a concentration target by the end of the 21st century.

The first targets should therefore be modest and begin to bend the trajectory of US emissions. A modest target would also ensure that long lived capital assets are not retired prematurely. If the target is set at a level that causes premature retirement of capital stock, the costs of legislation will be unacceptably high. The target should: (1) result in a price signal that provides incentives for regulated firms to reduce their emissions; (2) to consider the carbon price when evaluating their next generation of investments in long-lived assets; and (3) for consumers to alter their behaviour accordingly. The legislation also must recognize the century scale nature of the climate issue. In recognition of the temporal dimension of the problem, the legislation should not simply include targets for one period of time. It should incorporate targets in the mid to long terms in order to allow firms to consider investments in long lived capital assets that are critical to the nation's economic infrastructure.

g. The legislation should cover as many gases as possible in order to take advantage of reduction opportunities throughout the economy. However, Congress must be certain that data exists to incorporate non-CO<sub>2</sub> gases in a trading program.



h. Early action to reduce GHG emissions should be allowed to receive credits fungible in the cap and trade system. The creation of a price for carbon is intended to stimulate voluntary abatements by providing an incentive for the reductions, and flexibility in time is an important potential source for liquidity.

Companies should be provided credit for actions that reduced emissions prior to there being a legally binding requirement to do so. The actions need to be accurately measured and verified. The process for providing credit for early action must be rigorous in recognition of the fact that such credit would be provided from a fixed cap.

i. Const control is a key principle of climate legislation, and a safety valve may be one mechanism available to control costs. However, there also may be adverse impacts from the inclusion of one in legislation. The most robust possible const control mechanism is an effective market with the broadest possible supply of abatements.

Market design should avoid mechanisms which seek to directly manage, cap or maintain the associated price for emissions and/or to manage the associated supply and demand of allowances with a view to indirectly managing, capping or maintaining the price for allowances.

Setting a safety valve at the right level is very challenging. If the safety valve is set at an unacceptably low level, firms can simply buy their way out of the program by writing a check to the Government. This reduces the incentives established by the market to provide incentives for regulated firms to seek out the lowest cost reductions. The affect of this would be to reduce or eliminate the environmental benefits of the program.

Further, many of the proposed mechanisms which compromise the delivery of the environmental objective as a means to reduce upward pressure on price will effectively preclude linking to other emissions trading systems that do not share this design element. It is not in the long term interest of American business to operate under a price for carbon that is not derived from the broadest and deepest possible market.

j. The legislation should allow both domestic and international offsets in the legislation. This provides additional supply in the market and provides incentives for non-capped sectors to make investments in environmental beneficial activities.

IETA also does not believe that the use of offsets for compliance should be limited in any quantitative or qualitative fashion as some argue. This runs contrary to the fundamental logic of emissions trading. Such constraints only increase costs and reduce benefits for investments in beneficial activities. Verifiable offsets should be fully tradable within the market.

A well designed offset program can assist in the achievement of several key objectives. These include:



- Creating greater compliance opportunities for regulated firms reduces the potential for premature retirement of capital stock;
- The development of technologies required to address climate change in the longer term by enabling regulated firms the ability to manage their emissions over time, and
- Stimulating investment in environmentally beneficial activities in sectors outside the program.

Offsets should therefore be permitted from any possible source, subject only to the requirement for environmental integrity. Congress should provide guidance for the development of a domestic offset system with the broadest possible criterion for sectoral access.

Those concerned with offset programs believe they reduce the environmental integrity of the program. These are legitimate concerns. However, several programs that have been designed that attempt to address the concerns with environmental integrity increase risks to project developers and make it more difficult to raise capital to finance projects. The potential problems associated with the environmental integrity of offset programs, such as overcrediting and events which make offsets impermanent can be addressed.

We believe that the committee can learn from the approaches that have been developed to create offsets from the mechanisms under the Kyoto Protocol and other efforts such as Senator Bingaman's legislation which incorporates a tiered system to approve projects.

k. Any revenues generated by any auction of allowances should be used strictly as a form of trust fund for the greenhouse gas reduction objectives of the program, and not as a revenue source. The legislation would need to stipulate how the revenue is used and how it is accessed. We would be extremely concerned if similar to the Nuclear Waste Fund, revenue is raised and then cannot be accessed for the purposes for which it is envisioned

The purpose of an emissions trading system is not to serve as a carbon tax generating revenue, but to place a marginal cost on the use of the carrying capacity of the environment. IETA opposes in principle the diversion of revenues derived from the allocation of allowances with a GHG trading system to policy objectives other than the reduction of GHG emissions.

l. Effective policy to reduce GHG emissions must be based on three essential elements: carbon pricing, technological development, and other policies and measures targeting the removal of barriers to behavioural change. Leaving out any one of these elements will significantly increase the costs of action.

The development and deployment of a wide range of low-carbon technologies is essential in achieving the deep cuts in emissions that are needed. Carbon pricing gives



an incentive to invest in new technologies to reduce carbon; without it, there is little reason to make such investments.

The role of an emissions trading system is to efficiently provide the carbon pricing function, but it should be designed in such a way as to facilitate benefits to the other two elements. The removal of barriers may be stimulated by access to offset credits. Carbon pricing provides an investment signal, but is not itself sufficient. Technological development may require a structured mechanism to invest in long-term technology may be necessary to drive the necessary technological change in the required time frame, where the corresponding price signal necessary to stimulate that investment alone would be socially unacceptable.

There is a need for increased public funding to bring transformational technologies through R&D to demonstration and other policies to accelerate technologies to deployment stage to the point where they can compete based on the carbon price of the day. The interaction with a GHG cap and trade system should be structured to allow otherwise uneconomical projects in any access to the market price without compromising other sources of funding necessary to produce the project.

m. As with the level of the targets, this is a question of will and the costs the American public is willing to bear. Stabilizing concentrations of carbon dioxide will ultimately require participation by all major emitting countries. In addition to addressing the environmental concern, lack of participation by major emitters and all major trading partners would disadvantage the US economy, just as has occurred with the European Union.

IETA believes the strongest available mechanism to encourage comparable actions is through linkage of a US emissions trading system to worldwide systems.

In moving forward it must be also recognized that a GHG market would be a pure regulatory market and that some regulatory certainty must be provided to potential participants, especially liquidity providers. Any introduction of political uncertainty through a review or similar process should take place within clearly defined time frames that permit a reasonable horizon for investment decisions.

3. IETA believes that the Federal program which should serve as the primary example for a domestic climate change legislation are the pioneering US programs designed to address acid rain and smog. In these programs, the Congress has developed clear legislation and or provided EPA with the authority to regulate and the programs have been administered in a reasonable fashion. These programs provide regulated firms with a clear emissions target, trading rules and compliance requirements. Legislation that includes these principles will work and also make administration easier.

The benefits of the program are clear. The US Congressional Budget Office analysis of the SO<sub>2</sub> trading program concluded that the use of market mechanisms had



saved \$2.5 billion of the original \$5 billion of estimated compliance costs, and achieved greater reductions than required. The NOx trading programs designed to address ozone formation have also performed admirably. These systems have been the primary examples of emissions trading systems that have been emulated throughout the world.

4. We expect that the US will first develop a domestic program to reduce emissions and then will participate in the international effort to address climate change. The principles are that the US should adopt a modest limit in its domestic control program, the use of markets for compliance and initiate an ambitious technological development program in order to achieve steeper reductions at a later time period. These principles will likely guide the development of other nations' domestic and international responses to climate change. Connection to any other systems would take place on the basis of demonstrable benefit to American business.

The eventual connection of the US program with any international program that it is not party to would be facilitated by having a fungible commodity across systems. This fungible commodity will likely be the project based offsets that referred to Section 2. J. These will likely be the lowest cost reductions available in the market and as such US firms should be able to utilize them for compliance with their emissions limitations. The legislation should authorize the use of these instruments for for compliance. If US firms do not have access to them, they would be at a disadvantage with their global competitors that have access to these instruments.

5. IETA is a non-profit business organization that "is dedicated to ensuring that the objectives of the UNFCCC and ultimately climate protection are met through the establishment of effective global systems for trading in greenhouse gas emissions (GHG) by businesses, in an economically efficient manner while maintaining societal equity and environmental integrity".

IETA's membership is currently 147 companies of which 50% represent industrial organizations that see emissions trading as essential to meet existing or future regulatory constraints. The balance represent project developers, intermediaries, financial institutions, brokers, verifiers, legal firms, etc engaged in a new economic activity as a result of the GHG market. IETA's industrial membership collectively emits an amount equivalent to the combined GHG emissions of Germany and the United Kingdom.

The role of IETA is to provide input on design issues related to greenhouse gas emissions trading by advocating flexibility, openness, and encouraging optimum liquidity. IETA does not participate in the scientific debate over climate change or advocate legislation for mandatory caps and timetables. IETA's goal is to facilitate the establishment of efficient liquid emissions trading markets that will help participants to achieve compliance with regulatory regimes in the most cost effective manner.

In executing this mission, IETA has emerged as the pre-eminent voice of the business community in the UNFCCC process, serving as an active partner in the



evolution of the Clean Development Mechanism and Joint Implementation. IETA has played an important role in the development of the European Union's Emissions Trading Scheme. IETA has served as the meeting place for the business community to develop essential standards to facilitate market functioning across both of these critical pillars of the international carbon market.

We hope our comments prove useful and we look forward to working with the Committee.

Yours truly,

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International Emissions Trading Association